BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Dear CEO

Review and findings: Fast growing firms

Over the past year, the PRA has undertaken a review of 20 non-systemic deposit taking firms with different business models and activities; most of which exhibit faster asset growth than the market as a whole ('fast growing firms' or 'FGFs'). The review aimed to test the financial resilience of fast growing firms and enhance the PRA's knowledge of the funding and lending markets in which they operate. It comprised three elements:

1. ICAAP stress testing, based on the Bank of England's published 2018 stress scenario;[1]
2. asset quality reviews; and
3. funding and lending analysis.

We thank all participating FGFs for their engagement. This letter communicates our wider overall findings from the review and highlights **in bold** the aspects of risk management and control that we consider all firms should be adopting.

Overall findings

The review was a valuable exercise and we have gained considerable insights into the markets in which the FGFs operate, the role they play in lending to the real economy and basis for their growth plans. Although still small relative to the major UK banks, FGFs play an important role in lending to some sectors of the economy, specifically SMEs and buy-to-let investors.

We used peer comparisons and insights derived from the asset quality reviews, and our funding and lending analysis, to assess the robustness of stress tests included in the individual ICAAPs of the FGFs. This review has provided reassurance about the overall resilience of the sector as a whole while identifying some weaknesses in individual FGFs' risk management practices which require attention. Given the relatively early stage of development of many FGFs, identification of some weaknesses is not unexpected. However, **our findings warrant a more general reminder of the importance for all firms to ensure their governance and risk management capabilities remain aligned with their business model risk profile and appetite.**

Below we highlight our key findings across the three elements:

Element 1: Stress testing

The review's approach to ICAAP stress testing utilised the Bank of England's published 2018 annual cyclical scenario (ACS), the same scenario applied to the UK major banks. This scenario is more severe than the global financial crisis and, in the judgement of the Financial Policy Committee (FPC), encompasses a wide range of UK macroeconomic outcomes that could be associated with the UK's withdrawal from the EU. The 2018 scenario incorporates deep simultaneous recessions in the UK and global economies and large falls in asset prices. On a start-to-trough basis:

- UK GDP falls by 4.7%.
- UK residential property prices fall by 33%.
- UK commercial real estate (CRE) prices fall by 40%.

[1] Key elements of the 2018 stress test.

- UK unemployment peaks at 9.5%.
- Bank Rate rises to 4%.

Stress testing is an important tool that all firms should use to understand the potential vulnerabilities in their business models and to evidence that they have sufficient financial resources to withstand stress events. Our review work found that many FGFs needed to strengthen further their stress analysis and stress management capabilities. We found three main areas of weakness:

i. Most FGFs were overly optimistic about the potential impact of a stress scenario on their business. This was most apparent in their assumptions about stressed impairment rates that could emerge and their ability to raise capital, dispose of parts of their business, or widen their margins in the context of a market-wide stress.
ii. Many FGFs did not demonstrate an understanding of the stress drivers for their business, were unable to explain the assumptions made in their stress testing models, and/or to analyse the sensitivities of their business models to these assumptions.
iii. Where FGFs identified management actions to be taken in the event of stress, these tended to be poorly defined and lacking clear trigger points for when the action would be undertaken.

The results of our review highlight the vital role of robust governance in delivering sound stress testing. **We expect all firms to demonstrate effective engagement and challenge by senior management and boards, with stress testing integrated into the business**. Section 14 of the 2019 Bank of England stress testing guidance highlights a number of sources that firms can reference to support development of an effective stress testing framework.[2]

In our review of stress test outcomes, our overall concern was that FGFs could be underestimating the potential losses that could arise on their loan portfolios under the given scenario. This finding may reflect the fact that many FGFs have only existed during relatively benign credit conditions and have not experienced a downturn. In reviewing their own stress test results, few FGFs explicitly took account of the average impairment rates that are published as part of the results of the Bank of England's annual stress test for the major UK banks. **Although these published numbers are average rates on broad portfolios, so may not be directly applicable, they are a helpful reference point and cross-check for an assessment of the risk profile of a particular loan book and how it might behave under stress.**

In general, FGFs exhibit concentrations in higher-risk market segments which may be more vulnerable to stress. **All firms should ensure risk concentration is taken into account in their provisioning and stress models.**

Many FGFs included ambitious growth plans in their analysis and therefore expected the additional income from new business to offset higher impairment charges on previous business, to a greater or lesser extent. While we recognise that some firms may be able to capitalise on opportunities during a market-wide stress, **we do not consider it appropriate to assume that significant growth would be available in generally falling markets**.

All firms should ensure that the management actions they propose in their ICAAP stress test are consistent with the stress scenario used; we would be sceptical of any firms' expectations that they will be able to raise new capital in a market-wide stress scenario; similarly, expectations for the sale of a business unit to release capital may not realistically be executable in the given stress scenario, or may not yield the full capital benefit anticipated.

Element 2: Asset quality reviews

Many of the FGFs operate in higher credit risk segments of the lending market. Some FGFs were able to demonstrate that they have the credit expertise and control framework commensurate with taking this level of credit risk. However we found weaknesses at others:

i. Risk appetite frameworks were still evolving and generally reflected the particular FGF's stage of development and maturity. Risk appetite statements of these FGFs tended to be high level and did not fully capture risks or include sufficiently granular metrics to enable the level of risk to be adequately monitored. **Firms can seek to address this through broadening the range of risk**

[2] https://www.bankofengland.co.uk/-/media/boe/files/stress-testing/2019/stress-testing-the-uk-banking-system-2019-guidance.

metrics and enhancing both data quality and risk MI, as and when individual portfolios become more material in size.

ii. Many FGFs had untested collections capability and it was unclear to us how effective their plans for scaling up collections activity would be under stress. In some cases, **forbearance practices were not in line with industry standards; poor practice could potentially mask the level of arrears, delay appropriate recovery actions and thereby impact overall book performance in a downturn**.

iii. Some FGFs displayed weaknesses in underwriting of commercial loans. We observed a number of instances of weak financial analysis, limited evidence of challenge and high levels of lending outside of policy (on the basis of exceptions). **Firms are reminded to be mindful of the speed of decision making in commercial lending cases and whether this might be compromising the quality of analysis and robustness of the underwriting process.**

As highlighted above, many FGFs may not have experienced an economic downturn, but need to ensure they are prepared to react quickly in the event that credit conditions change. Preparatory work would include planning for how to manage rising levels of problem loans and to scale up collections resources/activity. **Better FGFs ensured that their risk functions remain adequately resourced[3] with experienced staff to provide challenge and oversight. This practice should guard against pressure to meet growth targets leading to them taking on unplanned higher levels of risk**.

We observed some areas of weakness in some FGFs' information provided to management and boards (MI); for example, we saw little evidence of FGFs segmenting their credit risk MI by multiple (layered) risks for either new business or stock. **It is our observation that firms benefit from MI which provides sufficiently detailed information on key loan book risk characteristics or combinations of risk characteristics, which could identify potentially vulnerable segments.** Some forbearance MI did not sufficiently monitor the flow and stock of forborne loans, nor the performance of cases which had exited forbearance; we consider the inclusion of both of these elements to be good practice from our observations.

Element 3: Funding and lending analysis

This analysis produced findings consistent with past analysis we have shared at conferences and through supervisory work.

A number of FGFs exhibited a lack of diversity in funding sources, being almost entirely reliant on funding from competitively priced, short-term fixed rate retail deposits. FGFs were not found to be disproportionately reliant on wholesale funding.

FGFs generally expected to raise additional easy access, notice and fixed rate retail funding over the coming years in order to support this balance sheet growth, refinance Term Funding Scheme (TFS)[4] drawings (ahead of deadlines for repayment) and replace maturing fixed term deposits. This approach, compounded by a risk of concentrated maturities, may place pressure on profitability if competitive pressures cause retail funding spreads to rise. Despite this, the analysis showed an element of over optimism in funding spreads assumed in many FGFs' plans.

More widely, most FGFs' pursuit of aggressive balance sheet growth targets was driven from the asset side of the balance sheet requiring firms to maximise funding from all available funding sources including non-core funding such as secured funding, wholesale funding, SME and corporate deposits, all of which could increase execution and refinance risks.

Better firms took into account various market pressures as well as their own ability to differentiate pricing on both sides of the balance sheet in both their baseline and stress testing projections.

[3] Proportionately to the business model and the risks being incurred.

[4] The August 2016 Bank of England Term Funding Scheme provided funding to participating deposit taking firms at interest rates close to Bank Rate. The primary objective of the scheme was to reinforce the pass-through of the August 2016 cut in Bank Rate to the interest rates faced by households and companies.

Next steps

The review of FGFs has provided us with important insights into the risk drivers of their business models and we have identified some wider lessons that we consider it important to bring to your attention in this letter. We will be providing further feedback at our upcoming conference session for Chairs and Non-Executive Directors of non-systemic UK Banks and Building Societies in July. You can expect your supervisory team to discuss the points raised in this letter with you as part of our ongoing supervisory engagement.

If you have any queries about the content of this letter, please contact your supervisory team.

Yours sincerely

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